

prudently devoted to the public utility enterprise by the utilities' owners.”<sup>74/</sup> In *Federal Power Comm’n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), for example, the Court cited Justice Brandeis’ opinion in *Southwestern Bell* to support the rule that “there be enough revenue not only for operating expenses *but also for the capital costs* of the business. These include service on the debt and dividends on the stock.” *Id.* at 603 (emphasis added). As AT&T/WorldCom acknowledge, *Hope* states that a rate order is compensatory if it provides “the opportunity for a return on *investment*.” AT&T/WCom Opp. 105 (emphasis added). There can be no return *on* investment until there has been a return *of* investment.

The necessity of using past prudent investment as the benchmark for evaluating whether a rate is confiscatory is even more pronounced here, where Verizon VA has not *voluntarily* dedicated its plant to providing UNEs to competitors. Instead, Verizon VA was compelled to enter that particular line of business, which is entirely unrelated to the retail telecommunications services it offers as a public utility. Moreover, to the extent Verizon VA made its investments pursuant to the regulatory regime that existed prior to the 1996 Act, the taking at issue occurred at the point of its forced dedication to the new regime, and thus prior to the imposition of TELRIC pricing, the government must preserve the opportunity to recover the capital invested before the shift in regulatory regimes. In *Duquesne*, the Supreme Court determined that a new ratemaking methodology was not confiscatory because it produced recovery that was sufficient as measured *under the old methodology*. 488 U.S. at 312. The Commission has likewise

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<sup>74/</sup> *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 309 (1989) (citing *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm’n*, 262 U.S. 276, 291 (1923) (Brandeis, J., dissenting)); *see also Democratic Central Committee v. WMATA*, 485 F.2d 786, 808 (D.C. Cir. 1973) (“It is well settled that utility investors are entitled to recoup from consumers the full amount of their investment in depreciable assets devoted to public service.”).

recognized the need to consider the impact of the transition to a forward-looking ratemaking methodology on the recovery of past prudent investment. VZ-VA AFR at 75 n.86.

The Constitution also protects a private party from being compelled to provide service without compensation for the *ongoing* costs that will necessarily be incurred by that party. VZ-VA AFR at 75-76. AT&T/WorldCom do not contest this rule. Indeed, *FERC v. Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979), which they cite, actually supports it by adverting to a procedure for a producer to obtain special relief when its “out of pocket” expenses exceed the revenues from area rates. Thus, UNE rates are confiscatory if they fail to compensate a utility for the actual forward-looking costs that the utility will necessarily incur to provide those elements.

**B. The “Market Value” Theory Does Not Shield The *Order’s* UNE Rates From Constitutional Scrutiny.**

AT&T/WorldCom imply that the *Order’s* UNE rates are not confiscatory because they allegedly reflect the “market value” of those facilities. AT&T/WCom Opp. at 104. This is wrong. Market value cannot be used as the standard of compensation in the absence of an objective standard of comparable and reliable market transactions.<sup>75/</sup> As the Supreme Court has said, in the absence of such transactions, market value is merely a “guess.”<sup>76/</sup> But there is no free

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<sup>75/</sup> *United States v. Virginia Elec. & Power Co.*, 365 U.S. 624, 633 (1961); *United States v. John J. Felin & Co.*, 334 U.S. 624, 630 (1948) (plurality opinion).

<sup>76/</sup> *United States v. Miller*, 317 U.S. 369, 374-75 (1943). *See also United States v. 564.54 Acres of Land*, 441 U.S. 506, 513 (1979) (listing “public facilities such as roads or sewers” as within the category of property “so infrequently traded” as to render the concept of market value meaningless); *Duquesne*, 488 U.S. at 316 n.10 (noting the “practical problems” with fair value, which might be overcome by the emergence of a real “market for wholesale electric energy” that “could provide a readily available *objective* basis for determining the value of utility assets” (emphasis added)).

market for UNEs, and thus no direct way to determine the actual “market value” of UNE leases.<sup>77/</sup>

One way to estimate “market value” in the case of a regulated utility would be to measure the opportunity cost, *i.e.*, the revenue that the utility would receive from its own use of the assets that are taken. “[W]hen the property is of a kind seldom exchanged, it has no ‘market price,’ and then recourse must be had to other means of ascertaining value.” *Kimball Laundry Co. v. United States*, 338 U.S. 1, 6 (1949). A traditional means of ascertaining the value of utility property is its earning capacity. For example, when the government condemns utility property for the purpose of continuing to operate it as such, the utility is entitled to be compensated for the value of its franchise — that is, its ability to obtain revenue from retail customers by charging rates allowed by law.<sup>78/</sup> Accordingly, if “market value” were the relevant measure of compensation, Verizon VA would be entitled to recover the value of the income stream of retail revenues that

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<sup>77/</sup> Indeed, the closest analogy to a “market transaction” in this context would be the sale of exchanges in the open market. Such sales have yielded a per-line price in the range of \$3,200, which is substantially in excess of the UNE rates here. See Richard G. Klugman, CFA, Regina Bienstock, William J. Cook & Andrew R. Tuttle, *Telecommunications Services, Shelter from the Storm: Initiation of Rural Telcos*, Jeffries & Company, Inc., May 2002, at 17; Michael J. Balhoff, CFA, Christopher C. King, & Bradley P. Williams, *Legg Mason, Equity Research*, The RLC Monitor, Winter 2003 Vol. 6 (2003) at 39; Michael I Rollins, CFA, Michael G. Chung, & John Santo Domingo, CFA, *ALLTEL Corp. - A Different Kind of Telecom Company*, Salomon, Smith, Barney, Telecommunications Wireless Services, March 15, 2002, at 22; Andrew Hammerling, Richard Y. Choe, & Robert Dezego, *CenturyTel, Inc.: Increases Scale with 675,000 Access Lines in Alabama and Missouri for \$2.159 Billion; Reiterates Guidance for 3Q01*, Banc of America Securities, Wireline Telecommunications Services, Oct. 23, 2001, at 1; Martin Dropkin, Daniel P. Reingold, *CenturyTel, Inc.: Initiated Coverage with Buy; \$37 Target Price*, Credit Suisse First Boston, Feb. 15, 2002, at 8.

<sup>78/</sup> See *Monongahela Navigation Co. v. United States*, 148 U.S. 312, 329 (1893); *Willcox v. Consolidated Gas Co.*, 212 U.S. 19, 44 (1909); *United States ex rel. TVA v. Powelson*, 319 U.S. 266, 282 & n.12 (1943); *Kimball Laundry*, 338 U.S. at 12-13; see also *Smyth v. Ames*, 169 U.S. 466, 546-47 (1898) (fair value includes “the probable earning capacity of the property,” along with its original and reproduction cost).

Verizon would have received but for the federal government's taking of the UNEs on behalf of CLECs.<sup>79/</sup>

By contrast, the rates adopted in the *Order* are *not* a valid proxy for the fair market value of Verizon VA's property. As discussed above and in Verizon VA's application for review, the *Order* adopts extreme and hypothetical assumptions that bear no relation to the real-world costs that Verizon VA incurs to provide UNEs; in fact, in some cases, such as high capacity loops, the *Order* does not even purport to measure costs. And the *Order* repeatedly rejects Verizon VA's proposed rates and inputs on the erroneous ground that such proposals allegedly reflect Verizon VA's actual forward-looking costs. Accordingly, the resulting rates cannot even arguably be used as a realistic proxy of the fair market value of the real world network.

**C. The "Total Company" Theory Does Not Shield The *Order's* UNE Rates From Constitutional Scrutiny.**

AT&T/WorldCom also err in arguing that the *Order's* UNE rates are not confiscatory because they have not jeopardized the financial integrity of Verizon Communications Inc. as a whole. AT&T/WCom Opp. at 106, 108, 111-113. The UNE rates must be compensatory in and of themselves for the capital dedicated to providing such UNEs. Verizon Communications Inc.'s revenues from other sources — including both retail revenues subject to the jurisdiction of other states and revenue from competitive lines of business — may not be considered in evaluating whether the *Order's* UNE rates are confiscatory.

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<sup>79/</sup> AT&T/WorldCom's reliance on *Market Street Railway Co. v. Railroad Comm'n*, 324 U.S. 548 (1945), is therefore misplaced. In *Market Street*, the utility's financial distress resulted from changes in the market, not from regulatory action. Higher rates would not have helped the utility. 324 U.S. at 556, 566-67, 568. The Court expressly distinguished that situation from the one Verizon VA faces, in which "public regulation curtailed earnings otherwise possible." *Id.* at 554; see also *id.* at 566, 568.

As an initial matter, it is axiomatic that where the government forcibly occupies a portion of a firm's property, it must fully compensate the firm for the portion so taken. See *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 435-36 (1982). It is no answer to say that the firm's other remaining operations may nonetheless allow it to continue to operate at a profit. That is why the government unquestionably could not occupy and convert a General Motors plant to the production of tanks without fully compensating General Motors for the property taken. The same principle applies here where a portion of Verizon VA's property has been forcibly dedicated to the use of its competitors — a business it did not choose to enter. Under those circumstances, the government must fully compensate Verizon VA for the property that is dedicated to that compulsory regime.

In fact, the law is clear that even where a firm *voluntarily* dedicates a portion of its property to a regulated business, a regulator may not force the portion of the business it is regulating to operate at a loss and claim that the deficiency can be covered by other parts of the firm's business. Thus, in *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396, 399 (1920), the seminal case applying this principle, the Supreme Court held that regulators could not justify below-cost railway rates by claiming that the railroad was still profitable due to healthy returns in its competitive lumber business. As Justice Holmes explained, earnings from competitive operations are the firm's private property, and a firm "no more can be compelled to spend that [money] than it can be compelled to spend any other money to maintain a railroad for the benefit of others who do not care to pay for it." *Id.*

The same underlying principle is reflected in the rule that a regulator may not justify deficient rates by pointing to revenues from operations under a different sovereign's jurisdiction. As the Supreme Court has explained: "The state cannot justify unreasonably low rates for

domestic transportation, considered alone, upon the ground that the carrier is earning large profits on its interstate business, over which, so far as rates are concerned, *the State has no control.*” *Smyth v. Ames*, 169 U.S. at 541 (emphasis added); *see also Smith v. Illinois Bell Tel. Co.*, 282 U.S. 133 (1930). Thus, as the Commission itself has acknowledged, in conducting a takings analysis, the agency “may not consider incumbent LECs’ revenue derived from services not under our jurisdiction.” *Local Competition Order* ¶ 737 n.1756.

The “total effect” test from *Duquesne* does not support AT&T/WorldCom’s position. In *Duquesne* and *Hope*, the companies at issue were regulated monopolies in *all* their operations and had voluntarily dedicated their operations to the businesses that were being regulated. In those cases, therefore, it was proper to consider the company’s overall revenue from all operations in determining the sufficiency of a rate order. But those cases clearly do not mean that, where a regulatory regime reaches only part of a business, that regulator can justify a non-compensatory rate on a regulated service by claiming that revenues from sources outside that regime make up the difference, especially where the relevant part of the business was *not* voluntarily dedicated.<sup>80/</sup> Further, today, *all* of Verizon VA’s services are subject to competition from CLECs, wireless providers, cable operators, and others. Thus, any attempt to increase non-UNE rates to make up for shortfalls in the UNE rates could not work. There is a dynamic relationship between UNE rates and Verizon VA’s retail revenues: as UNE rates drop, CLECs are able to undercut Verizon VA’s retail rates and capture Verizon VA’s customers. Raising Verizon VA’s retail rates accordingly would only accelerate Verizon VA’s loss of customers to

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<sup>80/</sup> See *Brooks-Scanlon*, 251 U.S. at 399; *see also Calfarm Ins. Co. v. Deukmejian*, 48 Cal.3d 805, 819, 258 Cal. Rptr. 161, 168, 771 P.2d 1247, 1254 (Cal. 1989) (statute providing relief from insurance rates based on financial condition of company as a whole invalid because allowed consideration of income from “sources unregulated by” the state; inquiry should have been limited to financial results of regulated lines).

CLECs. Thus, far from making up for a shortfall in UNE rates, increasing retail rates would simply exacerbate Verizon VA's loss.

**D. Verizon VA's Evidence Demonstrated a Substantial Constitutional Problem that the Commission Must Consider.**

Verizon VA has presented substantial evidence demonstrating that the *Order's* rates would be confiscatory under the applicable standards: The rates would *not* enable Verizon VA to recover either its past prudent investment or its actual forward-looking costs. *See* VZ-VA AFR at 72-77; Garzillo Decl. ¶¶ 29-31; Verizon Virginia Supplemental Testimony of Pat Garzillo at 1-16 (April 15, 2003). The Commission thus is obligated to consider Verizon VA's evidence so that it may properly evaluate Verizon VA's constitutional claims before any rates go into effect. Indeed, when a party raises allegations that particular rates are confiscatory, or are not "just and reasonable," the agency entrusted with that decision *must* evaluate that claim.<sup>81/</sup>

AT&T/WorldCom's assertions that Verizon VA's takings claim is untimely and improper, *see* AT&T/WCom Opp. at 113-15, are completely unfounded. The Supreme Court has expressly established that a challenge to the constitutional adequacy of UNE rates becomes ripe at the time that rates are set. *See Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 524-28 (2002). And AT&T/WorldCom's argument that the Commission should not consider Verizon VA's evidence at this point because the non-loop rates have not been definitively set, AT&T/WCom Opp. at 109-110, misses the point. The Supreme Court has observed that the Commission had committed to consider a claim of confiscation even "in advance of a rate

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<sup>81/</sup> *See, e.g., Jersey Cent. Power & Light Co. v. FERC*, 810 F.2d 1168, 1176-1179 (D.C. Cir. 1987) (where regulated entity presents serious allegations that rates may result in a taking, the agency *must* consider those allegations and look at the relevant evidence; failure to do so is reversible error); *Preseault v. ICC*, 494 U.S. 1, 11 (1990) (Constitution requires "reasonable, certain, and adequate provision for obtaining compensation at the time of the taking") (internal quotation marks omitted).

order.” *Verizon*, 535 U.S. at 528 n.39.<sup>82/</sup> That is particularly appropriate here, where all parties’ preliminary calculations of the rates — which will be finalized in a matter of days in the parties’ compliance filings — illustrate that the *Order*’s rates will not recoup Verizon VA’s prudent historical investment and actual forward-looking costs. And whatever the precise rates, the Commission is obligated to consider whether they will cover such costs before allowing them to go into effect.

AT&T/WorldCom are also wrong that Verizon VA’s evidence fails to establish a *prima facie* takings claim. AT&T/WCom Opp. at 109. AT&T/WorldCom wrongly suggest that the Commission need not consider evidence of Verizon VA’s historical costs that is derived from Verizon’s ARMIS data. AT&T/WCom Opp. at 110. But the *Order* itself repeatedly relies on ARMIS data. *See Order* ¶ 298. And the Commission itself has stated that ARMIS is a reliable source of data.<sup>83/</sup> In addition, contrary to AT&T/WorldCom’s claim, the Supreme Court did not hold that Verizon’s ARMIS reports “have no credibility.” AT&T/WCom Opp. at 110. Although the Court expressed concern that net book value would not necessarily reflect the *economic* value of the facilities, it did not suggest that accounting records were unreliable as evidence of the extent of the utility’s actual investment. *Verizon Communications*, 535 U.S. at 517-18 (“the ‘book’ value or embedded costs of capital presented to traditional ratemaking bodies often bore

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<sup>82/</sup> The Due Process Clause of the Fifth Amendment also requires that a utility be afforded a meaningful opportunity to challenge rates as confiscatory. *See, e.g., Michigan Bell Tel. Co. v. Engler*, 257 F.3d 587, 593 (6th Cir. 2001); *Guaranty Nat’l Ins. Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990); *Calfarm Ins. Co. v. Deukmejian*, 771 P.2d 1247, 1254 (Cal. 1989).

<sup>83/</sup> *See e.g. Memorandum Opinion and Order, Joint Application by SBC Communications Inc., Southwestern Bell Telephone Co., and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Arkansas and Missouri*, 16 FCC Rcd 20719, 20748 ¶ 60 n.161 (2001) (noting that “ARMIS data is [] reliable because it is based on publicly available reported data”).

little resemblance to the economic value of the capital”). In any event, the net book value reflected in Verizon’s ARMIS reports is the product of depreciation schedules *required* by the Commission; indeed, the Commission has rejected attempts by Verizon to depreciate assets more quickly.<sup>84/</sup> Thus, Verizon VA has a constitutional right to recover its remaining unrecovered investment.

Likewise, the evidence Verizon VA submitted concerning its current retail revenues is relevant to show such a takings. AT&T/WorldCom’s effort to prove otherwise, *see* AT&T/WCom Opp. at 109, fail. Those revenues — less the costs that Verizon VA would avoid when providing only wholesale services — provide a reasonable proxy for the level of revenues that Verizon VA would need to cover its wholesale costs of providing UNEs while earning a reasonable rate of return.

Finally, AT&T/WorldCom are wrong that Verizon VA’s TELRIC studies do not provide a meaningful benchmark for its actual forward-looking costs of providing UNEs. *See* AT&T/WCom Opp. at 110. Their sole support for this argument is that the Bureau rejected Verizon VA’s proposed rates. But in rejecting Verizon VA’s proposed rates, the *Order* concludes — albeit erroneously — that those rates are too *close* to Verizon VA’s actual costs. And TELRIC necessarily produces an *understatement* of actual forward-looking costs, as Verizon VA has explained. VZ-VA Ex. 101 at 4-7, 21-25. Thus, Verizon VA’s proposed TELRIC rates are if anything an overly conservative proxy for (and therefore *understate*) Verizon VA’s actual forward-looking costs.

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<sup>84/</sup> *See* Report and Order, 1998 Biennial Regulatory Review — Review of Depreciation Requirements for Incumbent Local Exchange Carriers, 15 FCC Rcd (1999).

## CONCLUSION

For the reasons stated above, the Commission should grant Verizon VA's application for review.

Submitted by

Lynn R. Charytan  
Samir C. Jain  
Wilmer, Cutler & Pickering  
2445 M Street, NW  
Washington, DC 20037-1420  
(202) 663-6000

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Michael E. Glover  
Karen Zacharia  
Leslie V. Owsley  
Donna M. Epps  
Verizon  
1515 North Court House Road  
Fifth Floor  
Arlington, Virginia 22201  
(703) 351-3100

Dated: October 24, 2003